**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS NUMBER: 05-0363**
**Sales and Use Tax for 2004**

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## ISSUE

### I. Sales/Use Tax—Assessment on Purchase of Aircraft

**Authority:** IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-3-4; IC 6-2.5-5-8(b); IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; Form 7695; Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary,* Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

## STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in July 2004 which it leases to affiliated entity, BM. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

### I. Sales/Use Tax—Assessment on Purchase of Aircraft

## DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

In July 2004, Taxpayer purchased an aircraft and in August 2004 moved the aircraft to Indiana. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5 and IC 6-2.5-3-4. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from BM when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with the BM. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed

a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Analysis of the form and function

BM has a need for an aircraft to transport members and employees. Because Taxpayer and BM are related, many of the members and employees of Taxpayer and the affiliated entity are the same persons. If BM had purchased an aircraft or a fractional share in an aircraft, sales or use tax would have been due because no applicable tax exemption could be leveraged. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The 6% sales tax on $322,500 is $19,350. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of BM. Under FAA regulations, control of the aircraft has to be placed with BM. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of BM. The Department asked Taxpayer to produce copies of the insurance policies held by the related company, BM. Taxpayer did not produce copies of those insurance policies and stated that only Taxpayer maintains insurance coverage on the aircraft to protect its asset. However, the policy states:

> Item 6. AIRCRAFT USE. The policy shall not apply to any **Insured** while the **aircraft** is being used with the knowledge and consent of such Insured for any purpose involving a charge intended to result in financial profit to such **Insured** unless otherwise indicated herein. [bold original]

These statements indicate that the insurance covers the use of the aircraft by Taxpayer and no other use. This contradicts the leasing arrangement that Taxpayer has with the affiliated company. Taxpayer obtained insurance at a favorable rate based on the use it stated to the insurance company. But Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft—it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.

> …
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated company, BM, seek to limit liability and protect assets, but BM has not secured insurance for its operation of the aircraft. Since under Part 91, operational control has to be transferred to the lessee, it is the lessee—in this case BM—that bears liability when operating the aircraft. BM has not provided evidence that it has purchased insurance coverage on the aircraft. Taxpayer has stated that the only insurance policy on the aircraft is the one held and paid for by Taxpayer. The leases between Taxpayer and BM requires that the related company to maintain liability insurance covering public liability and property damage of no less than $1 million. The lease outlines other insurance requirements. The lack of insurance coverage by BM is an indication that the relationship between Taxpayer and the affiliated companies can be collapsed.

Application of the Sham Transaction Doctrine

The lease agreements and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helvering, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If the affiliated companies were required to purchase transportation services in accordance with FAA regulations, they would need to secure a third-party to provide them with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What the affiliated companies would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But the affiliated companies do not wish to pay those costs—and they need not. What the affiliated companies want is an aircraft of their own that they can control. And that is what they have acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated companies structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of BM; Taxpayer has to give the aircraft and operational control to the related company and it is required to maintain the aircraft and pay the necessary associated expenses.

The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $120. Taxpayer acknowledges the fair market value comparison rate is around $280 per hour. Taxpayer states that the rental rate paid by the affiliated companies is reduced because it is responsible for maintaining the aircraft. The net effect of all this is that BM gets what it wanted all along—control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales and use tax due. If BM had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as it has, while it still has to pay those associated costs, the lease payments made to Taxpayer remain in the coffers of those who have ownership interests—the members. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by BM. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and BM is interfamilial. There is not rental and leasing to others; it is renting and leasing to self. On the lease, the member who signs for Taxpayer is the same person who signs as member for BM. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

## FINDING

For the reasons stated above, Taxpayer's protest is denied .

AAG/JMM—05xxxx